Nuance Communications, Inc.
Form 10-K/A
December 23, 2005

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K/A
(Amendment No. 1 to Form 10-K)

(Mark One)

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended September 30, 2005

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission file number 0-27038
NUANCE COMMUNICATIONS, INC.
(formerly ScanSoft, Inc.)
(Exact name of Registrant as Specified in its Charter)

Delaware	**94-3156479**
(State of Incorporation)	*(I.R.S. Employer Identification No.)*
1 Wayside Road	**(781) 565-5000**
Burlington, Massachusetts 01803	*(Registrant s Telephone Number, Including Area Code)*
(Address of Principal Executive Offices, Including Zip Code)	

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:
None
SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:
Common Stock, par value $0.001 per share
Preferred Share Purchase Rights

Indicate by check-mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ

Indicate by check-mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ

Indicate by check mark whether the Registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2).
Yes þ No o

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o No þ

The aggregate market value of the outstanding common equity held by non-affiliates of the Registrant as of the last business day of the Registrant s most recently completed second fiscal quarter was approximately $258,528,278 based upon the last reported sales price on the Nasdaq National Market for such date. For purposes of this disclosure, shares of Common Stock held by officers and directors of the Registrant and by persons who hold more than 5% of the outstanding Common Stock have been excluded because such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily conclusive.

The number of shares of the Registrant s Common Stock, outstanding as of November 30, 2005, was 160,200,839.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant s definitive Proxy Statement to be delivered to stockholders in connection with the Registrant s 2006 Annual Meeting of Stockholders are incorporated by reference into Part III of this Form 10-K.

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EXPLANATORY NOTE

Nuance Communications, Inc. (the Company) is filing this Amendment No. 1 on Form 10-K/ A to amend its Form 10-K for the fiscal year ended September 30, 2005 as filed with the Securities and Exchange Commission on December 14, 2005 to correct certain errors in the footnotes to the Company s consolidated financial statements, each as described in more detail below. The errors had no impact on the consolidated balance sheet or consolidated statement of operations of the Company included in Part II, Item 8, Financial Statements and Supplementary Data or any other information in the Company s Form 10-K as originally filed. For the convenience of the reader, this Amendment No. 1 sets forth the complete text of the Form 10-K as so amended. This Amendment No. 1 does not reflect events that have occurred after the original filing of the Form 10-K or update the information set forth in the Form 10-K subsequent to such original filing date. In connection with the filing of this Amendment No. 1, the Company is including as exhibits to this Amendment No. 1 currently dated certifications from the Chief Executive Officer and Chief Financial Officer and currently dated consent letters from the independent registered public accounting firms.

Item 8. Financial Statements and Supplementary Data, Footnote 3, Acquisitions has been amended to correct a rounding error in the table that provided details of the preliminary allocation of the purchase price for the acquisition of Former Nuance; and, to correct a summation error in the table that provides details of the preliminary allocation of the purchase price for the acquisition of ART Advanced Recognition Technologies, Inc.

Item 8. Financial Statements and Supplementary Data, Footnote 8, Accrued Expenses has been amended to correct certain errors in the table, which relate to the September 30, 2005 accruals, to conform to reclassifications appropriately reflected on the Company s 2005 balance sheet but not in the footnote. The amounts originally reported and the corrected amounts are set forth below (in thousands):

	September 30, 2005	
	As Reported	Corrected
Accrued sales and marketing incentives	$ 2,994	$ 2,994
Accrued restructuring and other charges	5,805	5,805
Accrued professional fees	6,169	6,169
Accrued acquisition costs and liabilities	18,233	18,233
Accrued other	12,113	13,041
	$ 45,314	$ 46,242

In addition, the accrued expenses for the payment of costs associated with the consummation of the Company s acquisition of Former Nuance have been reduced from $14.0 million to $12.0 million.

Item 8. Financial Statements and Supplementary Data, Footnote 20, Pro Forma Results (Unaudited) has been amended to correct certain errors in the table which inadvertently omitted certain revenue and expense items. The amounts as originally reported and the corrected amounts are set forth below (in thousands, except per share data):

	Year Ended September 30, 2005		Nine Months Ended September 30, 2004	
	As Reported	Corrected	As Reported	Corrected

Revenue	$ 192,234	$ 282,348	$ 181,414	$ 181,414
Net loss	$ (44,503)	$ (47,206)	$ (59,638)	$ (57,557)
Net loss per basic and diluted share	$ (0.29)	$ (0.31)	$ (0.41)	$ (0.39)

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FORWARD LOOKING STATEMENTS

THIS ANNUAL REPORT ON FORM 10-K CONTAINS FORWARD-LOOKING STATEMENTS WITHIN THE MEANING OF THE FEDERAL SECURITIES LAWS THAT INVOLVE RISKS, UNCERTAINTIES AND ASSUMPTIONS THAT, IF THEY NEVER MATERIALIZE OR IF THEY PROVE INCORRECT, COULD CAUSE OUR RESULTS TO DIFFER MATERIALLY FROM THOSE EXPRESSED OR IMPLIED BY SUCH FORWARD-LOOKING STATEMENTS. ALL STATEMENTS OTHER THAN STATEMENTS OF HISTORICAL FACT ARE STATEMENTS THAT COULD BE DEEMED FORWARD-LOOKING, INCLUDING STATEMENTS PERTAINING TO: OUR REVENUE, EARNINGS, CASH FLOW AND LIQUIDITY; OUR STRATEGY RELATING TO SPEECH AND IMAGING TECHNOLOGIES; THE POTENTIAL OF FUTURE PRODUCT RELEASES; OUR PRODUCT DEVELOPMENT PLANS AND INVESTMENTS IN RESEARCH AND DEVELOPMENT; FUTURE ACQUISITIONS; INTERNATIONAL OPERATIONS AND LOCALIZED VERSIONS OF OUR PRODUCTS; OUR CONTRACTUAL COMMITMENTS; OUR 2006 REVENUE EXPECTATIONS AND LEGAL PROCEEDINGS AND LITIGATION MATTERS. YOU CAN IDENTIFY THESE AND OTHER FORWARD-LOOKING STATEMENTS BY THE USE OF WORDS SUCH AS MAY, WILL, SHOULD, EXPECTS, PLANS, ANTICIPATES, BELIEVES, ESTIMATES, PREDICTS, INTENDS, POTEN CONTINUE OR THE NEGATIVE OF SUCH TERMS, OR OTHER COMPARABLE TERMINOLOGY. FORWARD-LOOKING STATEMENTS ALSO INCLUDE THE ASSUMPTIONS UNDERLYING OR RELATING TO ANY OF THE FOREGOING STATEMENTS. OUR ACTUAL RESULTS COULD DIFFER MATERIALLY FROM THOSE ANTICIPATED IN THESE FORWARD-LOOKING STATEMENTS AS A RESULT OF VARIOUS FACTORS, INCLUDING THOSE SET FORTH IN THIS ANNUAL REPORT UNDER THE HEADING RISK FACTORS. ALL FORWARD-LOOKING STATEMENTS INCLUDED IN THIS DOCUMENT ARE BASED ON INFORMATION AVAILABLE TO US ON THE DATE HEREOF. WE WILL NOT UNDERTAKE AND SPECIFICALLY DECLINE ANY OBLIGATION TO UPDATE ANY FORWARD-LOOKING STATEMENTS.

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PART I

Item 1. *Business*

Introduction

Nuance Communications, Inc. (Nuance , the Company , we or our), formerly ScanSoft, Inc. (ScanSoft), is a le provider of speech and imaging solutions for businesses and consumers around the world. Our technologies, applications and services make user experiences more compelling by transforming the way people access, share, manage and use information in business and in daily life.

We market and distribute our products indirectly through a global network of resellers, comprising system integrators, independent software vendors, value-added resellers, hardware vendors, telecommunications carriers and distributors; and directly to businesses and consumers through a dedicated direct sales force and our e-commerce website *(www.nuance.com)*. The value of our solutions is best realized in vertical markets that are information and process intensive, such as healthcare, telecommunications, financial services, legal and government.

Nuance was incorporated in 1992 as Visioneer. In 1999, we changed our name to ScanSoft, Inc. and ticker symbol to SSFT. In October 2005 we changed our name to Nuance Communications, Inc., and in November 2005 we changed our ticker symbol to NUAN. Our corporate headquarters and executive offices are located at 1 Wayside Road, Burlington, MA 01803. Our telephone number is 781-565-5000. We have approximately 25 regional sales and research and development offices throughout North America, Europe and Asia.

On October 23, 2004, our Board of Directors approved a change in the Company s fiscal year end from December 31 to September 30, effective beginning September 30, 2004. All references in this Form 10-K to the period ended September 30, 2004, or fiscal 2004, refer to the nine months ended September 30, 2004. References to fiscal 2005, refers to the twelve month period beginning on October 1, 2004 and ending on September 30, 2005. References to fiscal 2003, refers to the twelve month period beginning January 1, 2003 and ending on December 31, 2003.

On October 18, 2005, we changed our name from ScanSoft, Inc. to Nuance Communications, Inc. Earlier, on September 15, 2005, we completed our acquisition of the company formerly known as Nuance Communications, Inc. For purposes of comparison and discussion, we will refer to this acquired company as Former Nuance .

Background

From our founding in 1992 until December 2001, we focused exclusively on delivering imaging solutions that simplified converting and managing information as it moved from paper formats to electronic systems. On March 13, 2000, we merged with Caere Corporation, a California-based digital imaging software company, to expand our applications for document and electronic forms conversion. In December 2001, we entered the speech market through the acquisition of the Speech & Language Technology Business from Lernout & Hauspie. We believed speech solutions would provide significant growth opportunities and were a natural complement to our imaging solutions as they serve similar vertical markets with information intensive requirements.

Our focus on providing competitive and value-added solutions for our customers and partners requires a broad set of technologies, service offerings and channel capabilities. We have made and expect to continue to make acquisitions of other companies, businesses and technologies to complement our internal investments in these areas. We have a team that focuses on evaluating market needs and potential acquisitions to fulfill them.

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In addition, we have a disciplined methodology for integrating acquired companies and businesses after the transaction is complete. Since the beginning of 2003, we have completed a number of acquisitions, including:

January 30, 2003 Royal Philips Electronics Speech Processing Telephony and Voice Control business units (Philips) to expand our solutions for speech in call centers and within automobiles and mobile devices.

August 11, 2003 SpeechWorks International, Inc. (SpeechWorks) to broaden our speech applications for telecommunications, call centers and embedded environments as well as establish a professional services organization.

December 19, 2003 LocusDialog, Inc. (LocusDialog) to expand our speech application portfolio with automated attendant solutions for business.

June 15, 2004 Telelogue, Inc. (Telelogue) to enhance our automated directory assistance solutions.

September 16, 2004 Brand & Groeber Communications GbR (B&G) to enhance our embedded speech solutions, which will make mobile phones accessible to the visually impaired using Nuance s text-to-speech technology.

December 6, 2004 Rhetorical Systems, Inc. (Rhetorical) to complement our text-to-speech solutions and add capabilities for creating custom voices.

January 21, 2005 ART Advanced Recognition Technologies, Inc. (ART) to expand our portfolio of speech solutions for handsets and mobile devices.

February 1, 2005 Phonetic Systems Ltd. (Phonetic) to complement our solutions and expertise in automated directory assistance and enterprise speech applications.

May 12, 2005 MedRemote, Inc. (MedRemote) to expand our position in healthcare markets and provide a more comprehensive dictation solution for medical providers and organizations.

September 15, 2005 Nuance Communications, Inc. (Former Nuance) to expand our portfolio of technologies, applications and services for call center automation, customer self service and directory assistance.

Market Opportunity

In the past decade, information has become an increasingly important source of capital for businesses and enterprises, and the speed and sophistication of information exchange through various means information systems, call centers, documents, mobile devices is often a defining characteristic of the most successful entities worldwide. Many organizations define their strategy, assess their ability to compete and manage their customer relationships based on the quality, diversity and availability of their information products, services and resources. The optimal format for vital business information is wide and varied, ranging from the spoken word in multiple languages and in multiple locations to paper, electronic files and Web content.

Confronted by exponentially increasing information through more and more channels, consumers and business personnel employ a variety of resources for retrieving information, conducting transactions and performing their jobs. The Internet, telecommunications systems, wireless and mobile networks, and related corporate infrastructure have emerged as a powerful global communications network and channel for conducting business. These electronic systems have fundamentally changed the way organizations and consumers obtain information, communicate, purchase goods and conduct business.

Businesses and manufacturers around the world share a common motivation to improve operating efficiency, enhance customer service and differentiate offerings. Customer satisfaction, employee productivity and company operating results can often be linked to an organization s ability to effectively manage, utilize and communicate information.

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We believe that making the user experience more compelling represents a significant opportunity to help simplify the way people access, share, manage and use information in business and in daily life. Our products and technologies make user experiences more compelling by transforming the way people interact with information and systems and automate manual processes and help enterprises, professionals and consumers increase productivity, reduce costs and save time.

We deliver premier, comprehensive technologies and services in two markets: speech and imaging. Our speech technologies enable voice-activated services over a telephone, transform speech into written word, and permit the control of devices and applications by simply speaking. Our imaging solutions eliminate the need to manually reproduce documents, automate the integration of documents into business systems, and enable the use of electronic documents and forms within database, Internet, mobile and other business applications. Our software is delivered as part of a larger integrated system, such as systems for customer service call centers, or as an independent application, such as dictation, document conversion or PDF, navigation systems in automobiles or digital copiers on a network. Our products and technologies deliver a measurable return on investment to our customers.

Overview of Speech Market

We deliver speech solutions that use the human voice to interact with information systems and devices and make user experiences more compelling. We are working toward our vision of the future where natural conversations are the preferred way people interact with automated systems and devices. To achieve this, we are investing in technologies and solutions which enable conversational, speech-based applications to become more dynamic, sound more natural and perform tasks on multiple devices that adapt to personal preferences. We are investing in three speech areas network speech, embedded speech and dictation.

Through network speech, embedded speech and dictation solutions, we offer a comprehensive and innovative portfolio of speech technologies, expertise and solutions. Every day, millions of users and thousands of businesses utilize our solutions by calling directory assistance, receiving account information over the phone, dictating patient records or telling a navigation system their destination. We have deployed more than 3,000 speech applications for some of the world s most respected companies.

Network Speech. Organizations are looking for ways to improve the quality of the customer care that they deliver, while reducing the associated costs and ensuring a positive customer experience. They seek to automate revenue-generating transactions requiring immediate delivery of goods and services. They also demand solutions that efficiently and effectively connect a mobile workforce with real-time enterprise information, including customer data, directory information and schedules.

Our network speech solutions allow users to direct their own calls, obtain information and conduct transactions by simply speaking naturally over any telephone. Our solutions are used within a wide range of applications, across many customer-service intensive industries, including financial services, telecommunications, healthcare, utilities, government, travel and entertainment. Our software is integrated into applications such as flight information, personal banking, directory assistance, equipment repair and claims processing. We provide an extensive portfolio of speech technologies and applications that offer superior accuracy, support up to 46 languages and make caller interactions more dynamic and natural. Our solutions adhere to global industry standards and we provide speech technologies and services in more languages than any other vendor.

We complement our technologies and products with a professional services organization that supports customers and partners with business and systems consulting project management, user interface design and application development assistance. Our professional services are designed to shorten time-to-market, assist customers, reduce implementation risks and improve our customers competitive position. We service our customers from principal offices located domestically in Boston, Menlo Park, New York and San Francisco and internationally in Aachen, Germany; London, Mexico City, Montreal and Sydney. In addition, we offer packaged solutions for applications that are common across a large set of customers and vertical markets.

We license our network speech products to enterprise businesses, such as those in the Fortune 1000, and telecommunications carriers. Although in certain cases we sell directly to our customer, the majority of our

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solutions are fulfilled through our channel networks comprised of telecommunications equipment companies, systems integrators and technology providers including Avaya, Cisco, Genesys, Intervoice and Nortel, that integrate our solutions into hardware and software platforms.

Embedded Speech. Automotive, mobile communications, consumer electronics and computer game manufacturers and their suppliers are accelerating the development of products that require enhanced voice control capabilities. In addition, a growing number of independent software and hardware vendors are incorporating voice control into multimedia applications and devices that allow users to interact with these systems by speaking.

Our embedded speech solutions add voice control capabilities to applications integrated in a variety of automobiles and devices, such as mobile phones, PDAs, consumer electronics and navigation systems. This technology identifies specific words and phrases at any moment in time, converting spoken words into instructions that control functions within applications. Our solutions support dynamic vocabularies and have sophisticated noise management capabilities that improve accuracy, even in noisy environments. Our products scale to meet the size and accuracy requirements for automotive and navigation systems and offer rapid application development tools, extensive compatibility with hardware and operating systems and support multiple languages. We include toolkits with our software that help developers add our technologies to applications such as navigation systems, hands-free cell phone devices and voice-activated controls in an automobile.

Our embedded speech solutions are used by automobile, cell phone, entertainment and aftermarket system manufacturers, and their suppliers, including Alpine, Bosch-Blaupunkt, Delphi, General Motors, LG, Microsoft, Motorola, Nokia, Pioneer, Samsung, Sony and Visteon. These technologies are included as part of a larger system, application or solution that is designed, manufactured and sold by our customers. These customers include handset and other device manufacturers and tier-one suppliers, companies whose size and importance qualifies them to be direct suppliers to the major automotive manufacturers, and in-dash radio, navigation system and other electronic device manufacturers.

Dictation. Organizations demand solutions that increase productivity by automating repetitive business processes, including the creation of documents, data entry and completing forms. They also look for ways to maximize the productivity of their existing workers, including those with disabilities, and to comply with government requirements relating to workplace safety and accessibility. Organizations also seek solutions that can reduce the cost associated with manual transcription of professional documents. Since most people can speak more quickly than they can type, speech is a natural and efficient way to interact with computers to address these problems.

Our Dragon dictation solutions increase productivity in the workplace by using speech to create documents, streamline repetitive and complex tasks, input data, complete forms and automate manual transcription processes. Our Dragon NaturallySpeaking solutions allow users to automatically convert speech into text at up to 160 words-per-minute, much faster than most people can type, while our Dragon MT (Medical Transcription) platform is a complete solution for automating the capture, processing and conversion of recorded dictation into electronic transcripts. Our software supports a vocabulary of more than 300,000 words that can be expanded by users to include specialized words and phrases, is designed to adapt to individual voice patterns and accents and is highly accurate, able to achieve accuracy rates of up to 99%.

Our solutions are valuable within enterprises and workgroups for a number of reasons. Our software can operate within a distributed network environment, where speaker profiles can be stored on a server and accessed from any networked computer. Our solutions can also speech-enable existing business systems and applications, including Microsoft Office, customer service and practice management applications. Our software allows a user to interact with a computer completely by voice, increasing the productivity of disabled workers and those suffering from repetitive stress injury. Our solutions can also help government agencies address accessibility mandates, such as those described in Section 508 of the U.S. Government Rehabilitation Act. We also deliver versions of our products that are specialized for the medical and legal markets.

The Dragon Dictation Solutions family of products delivers enhanced productivity for professionals and consumers that create documents and transcripts, and are available in versions that deliver specific capabilities important to legal and healthcare industries. Healthcare represents the most significant market opportunity for our dictation solutions, as more than $10 billion is spent each year to manually convert recorded dictation into electronic transcripts. We have expanded our capabilities within healthcare by enhancing Dragon Naturally-Speaking Medical and through the introduction of the Dragon MT Workflow System, an XML-based platform used by medical transcription teams to automate the way they capture, process and convert recorded dictation into electronic transcripts. The Dragon MT Workflow System, based upon technology gained from the acquisition of MedRemote, can reduce transcription processing costs up to 50% when compared to manual systems. A growing number of healthcare vendors and integrators, including Agfa, Cerner, Dictaphone, IDX and SoftMed Systems, have joined with Nuance to speech-enable their healthcare solutions.

We offer a range of desktop and server solutions, each with features that match a specific customer target. Our solutions are also used in enterprises and workgroups, particularly in the medical, legal, government, finance and education sectors. The Dragon NaturallySpeaking family of products includes legal and medical vocabularies; supports the creation of custom vocabularies; and delivers capabilities that allow a user to access the application from within distributed care provider facilities. Our dictation software is available in eight languages. We utilize a combination of our global reseller network and direct sales to distribute our speech recognition and dictation products.

Overview of Imaging Market

Every day, millions of people work with documents as paper, as PDF, on email and using word processing applications. The proliferation of the Internet, email and personal computer networks have greatly simplified the ability to share documents, resulting in an ever-growing volume of documents to be used and stored. Our ScanSoft Imaging Solutions family of products are used by millions to automate the conversion of paper and PDF into fully-formatted documents that can be edited; to turn any digital document or photograph into a secure PDF that can be easily shared; and to empower everyone to eliminate the costs associated with paper documents through easy-to-use scanning, document management and electronic document routing solutions.

Our ScanSoft Imaging Solutions are desktop applications that are used to reduce the time and costs associated with creating, sharing and using documents. We have versions of our products that enable us to provide solutions to OEM hardware vendors, home office, small business and enterprise customers.

Document and PDF Conversion. Despite the broad use of personal computers, there is no single standard for sharing and using documents. Millions of documents are shared every day as paper, as PDF and as electronic files in various word processing formats, creating barriers to productivity when people need to move existing documents between those formats. For example, manually reproducing a paper or PDF document in Microsoft Word, complete with text, columns and graphics, is both time consuming and costly. These productivity challenges are compounded whenever new formats are introduced into the market, such as the XML Paper Specification (XPS) format developed by Microsoft in support of future versions of Microsoft Office and Microsoft Vista.

Our solutions help people and businesses save time and money by automatically converting documents from one format to another for example turning existing paper documents and PDF files into fully-formatted documents that can be edited using Microsoft Office, Corel WordPerfect and other editing applications. Our OmniPage product family, uses Optical Character Recognition and page segmentation technology to deliver highly accurate document and PDF conversion, replacing the need to manually re-create documents. Our software preserves document formatting and provides editing capabilities that re-create the complex components in a typical document, including formatted text, columns, graphics, tables and spreadsheets. Our products can be used with existing business applications and enable the distribution and publishing of documents to email, Internet and mobile applications using standard file formats, including XML, HTML, PDF and Open eBook.

The proliferation of multifunction devices and digital copiers connected over a network has increased the number of documents that individuals within an enterprise are transforming into digital format. Our software solutions create a more efficient method to process static documents in enterprise content management and database systems (usually as searchable PDF representations), thereby enhancing the value of their investments in these systems. All of these documents can then be more easily archived, edited and combined within the enterprise.

Our solutions are used by individuals, and in professional office settings, particularly in the government, legal, finance and education sectors. Our OCR software is available in 11 languages. We utilize a combination of our global reseller network and direct sales to distribute our document conversion and PDF products. We license our software to companies such as Brother, Canon, Dell, HP and Xerox, which bundle our solutions with multifunction devices, digital copiers, printers and scanners.

We also license software development toolkits to independent software vendors, integrators and in-house developers to add document and PDF conversion capabilities to their applications. Our independent software vendor customers, who use our technology for production capture or desktop applications, include vendors such as Autodesk, Canon, EMC/Captiva, Filenet, Kofax, Microsoft, Sharp and Verity.

Digital Paper Management. As the volume and complexity of corporate data continues to multiply, organizations are increasingly challenged in their efforts to simplify the way they store and manage all of their paper and digital documents. The wide dispersion of documents makes finding information even more difficult, time-consuming and costly. As a result, businesses need solutions that allow individuals, workgroups or the entire organization to more efficiently organize, find and share business documents.

Our digital paper management solutions, the PaperPort product family, convert paper into digital documents that can be easily archived, retrieved and shared. Our software can be used in conjunction with network scanning devices to preserve an image of a document exactly as it appears on paper. Our software automatically indexes the scanned image, so that it can be stored together with other digital documents on a desktop, over a network or within an enterprise content management system. In a single search, users can quickly find scanned documents and existing digital files that match the search criteria.

Within enterprises, workgroups and distributed teams, our solution can also facilitate the movement of scanned paper and digital documents into email, print and other business applications. This streamlines the flow of documents between workers, decreasing the time and costs associated with managing and using paper documents. Our solution integrates with established file systems to simplify the transfer of documents between desktop and enterprise content management systems.

Our digital paper management solutions are used by individuals, and in enterprises and workgroups, especially those within the legal, healthcare, financial, government, real estate and education industries. Our digital paper management software is available in more than eight languages. We utilize a combination of our global reseller network and direct sales to distribute our digital paper management products. We also license our software to companies such as Brother, Hewlett-Packard, and Xerox, which bundle our solutions with multifunction devices, digital copiers, printers and scanners.

Better PDF for Business. PDF, a published format specification invented by Adobe Systems, has become a popular way to share same-as-paper documents through email, PC networks and on the Web. Over 50 vendors, including Nuance, have implemented solutions based upon the public PDF specification, which is also the basis for PDF-A, a new International Standards Organization (ISO) standard. With over $700 million per year spent on various PDF solutions worldwide, we believe that there is a market opportunity for PDF products targeted specifically at office workers and businesses.

Our Better PDF for Business product family is comprised of three desktop applications. PDF Converter, developed in collaboration with Microsoft, is an affordable solution used to turn existing PDF files into fully-formatted Microsoft Word, Microsoft Excel and Corel WordPerfect documents that can be edited. PD Create! is an affordable solution to enable the creation of PDF from all of your PC applications, including support for PDF security, font embedding and other advanced features. PDF Converter Professional is our flagship PDF application, providing businesses with an affordable alternative to Adobe Acrobat and Adobe

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Acrobat Professional. PDF Converter Professional enables users to view, manipulate and edit PDF documents, as well as create and complete PDF forms. Our solutions are compatible with public PDF specifications, and have proven to be a cost-effective alternative to those offered by Adobe Systems.

Our PDF solutions are used by individuals, and in enterprises and workgroups, especially those within the legal, healthcare, financial, government, real estate and education industries. Our PDF software is available in more than eight languages. We utilize a combination of our global reseller network and direct sales to distribute our PDF products.

Our Competitive Strengths

Core Technology Assets. In recent years, we have developed and acquired extensive technology assets, intellectual property and industry expertise in speech and imaging. Our technologies are based on complex mathematical formulas, which require extensive linguistic and image data, acoustic models and recognition techniques. A significant investment in capital and time would be necessary to replicate our current capabilities. We continue to invest in the advancement of our technologies to maintain our market leading position and to develop new applications. As of September 30, 2005, we had 391 full-time employees in research and development, and our technologies were covered by more than 500 patents and patent applications, expiring on various dates between 2005 and 2020.

Broad Distribution Channels. We maintain an extensive network of resellers to address the needs of specific markets, such as financial, legal, healthcare and government. We believe that our extensive channel relationships increase the difficulty for competitors to develop a similar channel network and make it difficult for our products to be displaced. In addition, our far-reaching channel network enables us to introduce new products quickly and effectively throughout the global marketplace.

Leading Market Share. We have a strong market position in most of our product categories and are the market leader in document and PDF conversion, network-based speech recognition and text-to-speech, and dictation. Organizations tend to look to established market leading vendors when making product selections. As the established brand in our markets, we believe we can target and win more partnership arrangements and new customers than our competition.

International Focus. The broad language coverage within our product offerings increases the likelihood that vendors selling globally will select our technology. Our language coverage is difficult for competitors to duplicate, and our presence in global markets limits the potential entry of new regional competitors. With more than one half of our employees located outside of North America, we are able to efficiently compete on a global basis.

Multiple End Markets. We license to a range of end markets and maintain a tiered distribution model that provides a diversified revenue stream and broad market exposure. We are not dependent on any single market segment or set of end customers and earn revenue from both established and emerging markets.

Specialized Professional Services. We complement our technologies and products with a professional services organization that supports customers and partners, particularly in speech, with business and systems consulting, project management, user interface design and application development assistance. Our professional services are designed to shorten time-to-market, assist clients, reduce implementation risks and improve clients competitive position.

Our Strategy

Participate Broadly In Speech. We intend to leverage our comprehensive technologies and leadership in speech to expand our opportunities in the call center, automotive, healthcare, telecommunications and mobile markets. We also intend to pursue emerging opportunities to use our speech technology within consumer devices, games and other embedded applications. To expand our position in speech, we intend to introduce new versions of our products and applications; complete new license agreements with customers and partners that will resell our technologies; and continue to make strategic acquisitions that we believe complement our existing solutions and resources in the telecommunications, automotive and electronics markets.

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Pursue Opportunities for Dictation in Healthcare. We intend to increase our investments and efforts in providing dictation solutions to the healthcare market where we believe there is a large opportunity to automate transcription processes and information workflow. We have formed a healthcare-specific sales organization to aggressively pursue sales into care provider organizations; expanded our reseller and system integrator channels within healthcare; and entered into OEM license agreements with leading healthcare IT hardware and software vendors.

Expand Worldwide Channels. We intend to expand our global channel network and build upon our existing distribution channels, especially in Europe, Asia and Latin America. Along these lines, we have added sales employees in different geographic regions and launched programs and events to help recruit new partners for our channel network.

Expand PDF and Imaging Solutions. We intend to enhance the value and functionality of our PDF and imaging solutions to enable enterprises to address the proliferation of PDF, the expanded use of content management systems, and the widespread adoption of networked multifunction and digital scanning devices. We intend to continue to introduce new and improved versions of our products to take advantage of developing market opportunities. We also plan to enhance our software development toolkits so our technologies can be integrated with more third-party and OEM solutions.

Pursue Strategic Acquisitions. We have selectively pursued strategic acquisitions to expand our technology, channel and service resources and to complement our organic growth. For example, during 2003 we completed the LocusDialog, SpeechWorks and Philips acquisitions, in fiscal 2004 we completed the Telelogue and B&G acquisitions, and in fiscal 2005 we completed the Rhetorical, ART, Phonetic, MedRemote and Former Nuance acquisitions. We intend to continue to pursue strategic acquisitions as a part of our growth strategy.

Sales, Distribution and Fulfillment

We market and distribute our products indirectly through a global network of resellers, comprising system integrators, independent software vendors, value-added resellers, hardware vendors, telecommunications carriers and distributors; and directly through our dedicated direct sales force and through our e-commerce website *(www.nuance.com)*. As of September 30, 2005, we had 300 sales and marketing employees worldwide.

We have established relationships with more than 2,000 channel partners, including leading system vendors, independent software vendors, value-added resellers and distributors, through which we market and distribute our products and solutions. In speech, companies such as Avaya, Bosch-Blaupunkt, Cisco, Delphi, Dictaphone, Genesys, LG, Microsoft, Nokia, Nortel, Samsung and Visteon embed our technologies into telecommunications systems and automotive, PC, handset, healthcare or multimedia applications. In imaging, companies such as Brother, Dell, Hewlett-Packard, Visioneer and Xerox include our technology in digital copiers, printers and scanners, as well as multifunction devices that combine these capabilities. In addition, companies such as Corel, Canon, Captiva, Kofax, Sharp and Verity embed our imaging technology into their commercial software applications.

We license our applications to enterprises, professionals and consumers through distribution and fulfillment partners, including 1450, Ingram Micro, Tech Data and Digital River. These distribution and fulfillment partners provide our products to computer superstores, consumer electronic stores, eCommerce Web sites, mail order houses and office superstores, such as Amazon.com, Best Buy, CDW, MicroWarehouse, Circuit City, CompUSA, Fry s Electronics, Office Depot, PC Connection and Staples.

In fiscal 2005 two distribution partners, Ingram Micro and Digital River, accounted for 11% and 9% of our consolidated total revenue, respectively. For fiscal 2004, Ingram Micro and Digital River accounted for 14% and 8% of our consolidated total revenue, respectively. Sales of our dictation, document and PDF conversion products and our digital paper management products represented approximately 20%, 20% and 9%, of our total revenue, respectively, for fiscal 2005, as compared to 17%, 25% and 9%, respectively in fiscal 2004.

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Proprietary Technology

We exploit our proprietary technology, trade secrets, know-how, continuing technological innovations and licensing opportunities to maintain our competitive position. We rely on patent law, copyright law, trade secret laws, secrecy, technical measures, licensee agreements and non-disclosure agreements to protect our technology, trade secrets and other proprietary rights. Our policy is to file patent applications to protect technology, inventions and improvements that are important to the development of our business, to maintain a technological advantage over our competitors and to generate licensing revenue. In this regard, we have obtained patents that directly relate to our products. Our speech and imaging technologies are covered by more than 500 patents and patent applications. These patents expire on various dates between 2005 and 2020.

To protect our ownership rights in our software products, we license our products to OEMs and resellers on a non-exclusive basis with contractual restrictions on reproduction, distribution and transferability. In addition, we generally license our software in object code form only. We license certain of our software products to end-users by use of a shrink-wrap or click wrap customer license that restricts the end-user to personal use of the product.

We require our employees to execute confidentiality and invention assignment agreements in order to protect our proprietary technology and other proprietary rights. We also rely on trade secrets and proprietary know-how to protect our proprietary rights.

Research and Development

The market for our products and services is characterized by rapid technological change, frequent new product introductions and enhancements, evolving industry standards, and rapidly changing client requirements. As a result, we believe that our future growth is highly dependent on the timely and efficient introduction of new and updated products and technology. As of September 30, 2005, we employed 391 people in research and development, a majority of whom are located in international locations. Our employees based in overseas facilities extend our global focus while often lowering our overall cost of research and development. To promote efficiency in our research and development efforts, we have organized the effective use of global development teams and a comprehensively integrated development process. In addition, we have developed and refined our time-to-market process, which contributes to cost-effective resource management while promoting technology sharing across programs.

Our future success will depend in part on our ability to anticipate changes, enhance our current products, develop and introduce new products that keep pace with technological advancements and address the increasingly sophisticated needs of our clients. Our research and development expenses for the twelve months ended September 30, 2005, the nine months ending September 30, 2004 and the twelve months ended December 31, 2003 were $38.9 million, $26.2 million and $33.9 million, respectively. We expect that we will continue to commit significant resources to research and development in the future. To date we have not capitalized any research and development expenses and all costs have been expensed as incurred.

International Operations

We currently have offices in a number of international locations including: Australia, Belgium, Canada, Denmark, England, France, Germany, Hong Kong, Hungary, Italy, Japan, the Netherlands, Poland, Spain, Sweden and Taiwan. The scope of our international operations includes research and development, customer support and sales and marketing. Our international research and development is conducted in Budapest, Hungary; Merelbeke, Belgium; Aachen, Germany; Montreal, Canada and Tel Aviv, Israel. Additionally sales and support offices are located throughout the world to support our current international customers and to expand our international revenue opportunities.

Geographic revenue classification is based on the country in which the sale originates. Revenue for the twelve months ended September 30, 2005 was 64% in the United States and 36% international, as compared to the nine months ended September 30, 2004 which was 68% in the United States and 32% international.

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For a discussion of risks attendant to our international operations, see Management s Discussion and Analysis of Financial Condition and Results of Operations Risk Factors *A significant portion of our revenue is derived from sales in Europe and Asia. Our results could be harmed by economic, political, regulatory and other risks associated with these and other international regions.*

Competition

There are a number of companies that develop or may develop products that compete in our targeted markets; however, currently there is no one company that competes with us in all of our product areas. The individual markets in which we compete are highly competitive, and are subject to rapid technology changes. Within speech, we compete with AT&T, Fonix, IBM, Loquendo, Microsoft, Philips, Telisma and Voice Signal. Within imaging, we compete directly with ABBYY, Adobe, I.R.I.S. and NewSoft. In speech, some of our partners such as Avaya, Cisco, Edify, Genesys and Nortel develop and market products that can be considered substitutes for our solutions. In addition, a number of smaller companies in both speech and imaging produce technologies or products that are competitive with our solutions in some markets. Current and potential competitors have established, or may establish, cooperative relationships among themselves or with third parties to increase the ability of their technologies to address the needs of our prospective customers.

Some of our competitors or potential competitors in our markets, such as Adobe, IBM and Microsoft, have significantly greater financial, technical and marketing resources than we do. These competitors may be able to respond more rapidly than we can to new or emerging technologies or changes in customer requirements. They may also devote greater resources to the development, promotion and sale of their products than we do. see Management s Discussion and Analysis of Financial Condition and Results of Operations Risk Factors *The markets in which we operate are highly competitive and rapidly changing, and we may be unable to compete successfully.*

Employees

As of September 30, 2005, we employed 1,112 people on a full-time basis, 515 in the United States and 597 internationally. Of the total, 391 were in product research and development, 300 in sales and marketing, 196 in professional service consulting, 72 in operations and support, and 153 in finance and administration. Our employees may be subject to collective bargaining agreements at a company or industry level in those countries where this is part of the local labor law or practice. We have experienced no work stoppages and believe that our employee relations are good. We have utilized the services of consultants, third-party developers, and other vendors in our sales, development, manufacturing activities and finance and administration functions.

Available Information

Our reports filed with Securities and Exchange Commission, including this Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to reports filed pursuant to Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended, are available free of charge on our website at www.nuance.com, as soon as reasonably practicable after such reports are filed electronically with the Securities and Exchange Commission.

Item 2. ***Properties***

Our corporate headquarters and administrative, sales, marketing, research and development and support functions occupy approximately 88,400 square feet of space that we lease in Burlington, Massachusetts. We

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also lease additional properties in the United States and a number of foreign countries. The following table summarizes our significant leased properties as of September 30, 2005:

Location	Sq. Ft.	Lease Term	Primary Use
Burlington, Massachusetts	88,400	May 2015	Corporate headquarters and administrative, sales, marketing, research and development and support functions.
Menlo Park, California(1)	49,500	August 2009	Sales, marketing and support functions.
Aachen, Germany(2)	30,000	March 2006	Research and development.
Budapest, Hungary	21,200	December 2006	Research and development.
Merelbeke, Belgium	20,100	April 2008	International headquarters and research and development.
Montreal, Quebec(3)	44,500	June 2006 to March 2013	Sales, marketing, research and development, customer support and order fulfillment functions.
Menlo Park, California(4)	140,900	July 2012	Not occupied.
Boston, Massachusetts(5)	35,600	September 2006	Not occupied.
New York, New York(6)	26,200	February 2016	Subleased to two separate third-party tenants.

(1) Comprised of three leases. These leases are for property assumed as part of our acquisition of Former Nuance. Two of these facilities are expected to be vacant beginning in January 2006. See Note 10 of Notes to Consolidated Financial Statements.

(2) The lease for this property was assumed as part of our Philips acquisition.

(3) Comprised of three leases, each assumed from an acquisition we have consummated.

(4) The lease for this property was assumed as part of our acquisition of Former Nuance. See Note 10 of Notes to Consolidated Financial Statements.

(5) Pursuant to an agreement between us and the landlord, this lease was terminated early in October 2005.

(6) The lease for this property was assumed as part of our SpeechWorks acquisition.

In addition to the properties referenced above, we also lease a number of small sales and marketing offices in the United States and internationally. As of September 30, 2005, we were productively utilizing substantially all of the space in our facilities, except for space identified above as Not occupied or that has been subleased to third parties. We believe that our existing facilities are adequate for our needs for at least the next twelve months.

Item 3. ***Legal Proceedings***

Like many companies in the software industry, we have from time to time been notified of claims that we may be infringing certain intellectual property rights of others. These claims have been referred to counsel, and they are in various stages of evaluation and negotiation. If it appears necessary or desirable, we may seek licenses for these intellectual property rights. There is no assurance that licenses will be offered by all claimants, that the terms of any offered licenses will be acceptable to us or that in all cases the dispute will be resolved without litigation, which may be time-consuming and expensive, and may result in injunctive relief or the payment of damages by us.

From time to time, we receive information concerning possible infringement by third parties of our intellectual property rights, whether developed, purchased or licensed by us. In response to any such circumstance, we have counsel investigate the matter thoroughly and we take all appropriate action to defend our rights in these matters.

On May 18, 2005, Nuance Communications, Inc. (Former Nuance) received a copy of a complaint naming Former Nuance and the members of the board of directors as defendants in a lawsuit filed on May 13, 2005, in the Superior Court of the State of California, County of San Mateo, by Mr. Frank Capovilla, on behalf of himself and, purportedly, the holders of Former Nuance s common stock. The complaint alleges, among other things, that Former Nuance s board of directors breached their fiduciary duties to Former Nuance s stockholders with respect to the Merger Agreement that was entered into with ScanSoft, Inc. The complaint seeks to declare that the Merger Agreement is unenforceable. The complaint also seeks an award of attorney s and expert s fees. We believe the allegations of this lawsuit are without merit and expect to vigorously contest the action.

On August 5, 2004, Compression Labs, Inc. filed an action against us in the United States District Court for the Eastern District of Texas claiming patent infringement. Damages are sought in an unspecified amount. In the lawsuit, Compression Labs alleges that we are infringing United States Patent No. 4,698,672 entitled Coding System for Reducing Redundancy. We believe this claim has no merit, and we intend to defend the action vigorously.

On July 15, 2003, Elliott Davis (Davis) filed an action against SpeechWorks in the United States District Court for the Western District for New York (Buffalo) claiming patent infringement. Damages are sought in an unspecified amount. In addition, on November 26, 2003, Davis filed an action against us in the United States District Court for the Western District for New York (Buffalo) also claiming patent infringement. Damages are sought in an unspecified amount. SpeechWorks filed an Answer and Counterclaim to Davis s Complaint in its case on August 25, 2003 and we filed an Answer and Counterclaim to Davis s Complaint in its case on December 22, 2003. We believe these claims have no merit, and intend on defending the actions vigorously.

On November 27, 2002, AllVoice Computing plc (AllVoice) filed an action against us in the United States District Court for the Southern District of Texas claiming patent infringement. In the lawsuit, AllVoice alleges that we are infringing United States Patent No. 5,799,273 entitled Automated Proofreading Using Interface Linking Recognized Words to Their Audio Data While Text Is Being Changed (the 273 Patent). The 273 Patent generally discloses techniques for manipulating audio data associated with text generated by a speech recognition engine. Although we have several products in the speech recognition technology field, we believe that our products do not infringe the 273 Patent because, in addition to other defenses, they do not use the claimed techniques. Damages are sought in an unspecified amount. We filed an Answer on December 23, 2002. On January 4, 2005, the case was transferred to a new judge of the United States District Court for the Southern District of Texas for administrative reasons. We believe that we have meritorious defenses and intend on defending the action vigorously.

In August 2001, the first of a number of complaints was filed, in the United States District Court for the Southern District of New York, on behalf of a purported class of persons who purchased Former Nuance stock between April 12, 2000 and December 6, 2000. Those complaints have been consolidated into one action. The complaint generally alleges that various investment bank underwriters engaged in improper and undisclosed activities related to the allocation of shares in Former Nuance s initial public offering of securities. The complaint makes claims for violation of several provisions of the federal securities laws against those underwriters, and also against Former Nuance and some of Former Nuance s directors and officers. Similar lawsuits, concerning more than 250 other companies initial public offerings, were filed in 2001. In February 2003, the court denied a motion to dismiss with respect to the claims against Former Nuance. In the third quarter of 2003, a proposed settlement in principle was reached among the plaintiffs, issuer defendants (including Former Nuance) and the issuers insurance carriers. The settlement calls for the dismissal and release of claims against the issuer defendants, including Former Nuance, in exchange for a contingent payment to be paid, if necessary, by the issuer defendants insurance carriers and an assignment of certain claims. The timing of the conclusion of the settlement remains unclear, and the settlement is subject to a number of conditions, including approval of the court. The settlement is not expected to have a material impact upon our financial condition or results of operations, as payments, if any, are expected to be made by insurance carriers, rather than by us. In July 2004, the underwriters filed a motion opposing approval by the court of the settlement among the plaintiffs, issuers and insurers. In March 2005, the court granted preliminary approval of the settlement, subject to the parties agreeing to modify the term of the settlement which limits each underwriter from seeking contribution against its issuer for damages it may be forced to pay in the action. In the event a settlement is not concluded, we intend to defend the action vigorously. We believe that we have meritorious defenses to the claims against Former Nuance.

We believe that the final outcome of these matters will not have a significant adverse effect on our financial position and results of operations. However, even if our defense is successful, the litigation could require significant management time and could be costly. Should we not prevail in any such litigation, our operating results, financial position and cash flows could be adversely impacted.

Item 4. ***Submission Of Matters To A Vote Of Security Holders***

On August 31, 2005, we held a special meeting of our stockholders at which the following actions were voted upon:

(a) To approve the issuance of shares of our common stock in connection with a two step merger pursuant to which (i) in the first step, Nova Acquisition Corporation, a wholly-owned subsidiary of Nuance, merged with and into Former Nuance, with Former Nuance surviving as a wholly owned subsidiary of Nuance and (ii) in the second step, Former Nuance will merge with and into Nova Acquisition LLC, a wholly owned subsidiary of Nuance, as contemplated by the Agreement and Plan of Merger, dated as of May 9, 2005, among ScanSoft, Nova Acquisition Corporation, Nova Acquisition LLC and Former Nuance.

Votes For	Votes Against	Abstained
73,389,095	1,301,760	70,940

(b) To approve the Stock Purchase Agreement, dated as of May 5, 2005, by and among ScanSoft and Warburg Pincus Private Equity VIII, L.P. and certain of its affiliated entities, and the issuance of the shares of our common stock and warrants to acquire shares of our common stock pursuant to the Stock Purchase Agreement.

Votes For	Votes Against	Abstained
73,262,457	1,402,386	96,952

(c) To approve the assumption of stock options outstanding under the Former Nuance stock option plans with an exercise price of $10.00 or less in the manner set forth in the Agreement and Plan of Merger.

Votes For	Votes Against	Abstained
69,339,309	5,255,338	107,148

PART II

Item 5. ***Market for the Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities***

Market for Common Stock

Our common stock commenced trading on the Nasdaq National Market on December 11, 1995 under the symbol VSNR, and traded under that symbol until March 3, 1999. Subsequent to March 3, 1999 and until November 21, 2005, our common stock traded under the symbol SSFT . Effective November 22, 2005, our common stock is now traded on the Nasdaq National Market under the symbol NUAN . As of November 30, 2005, there were outstanding

160,200,839 shares of common stock. The following table sets forth for the periods indicated the high and low sale prices for our common stock as reported on the Nasdaq National Market. As our fiscal 2004 included the period beginning January 1, 2004 and ending September 30, 2004 there is no fourth quarter in that fiscal year.

	High	Low
Fiscal 2005:		
First quarter	$ 4.51	$ 3.25
Second quarter	4.80	3.43
Third quarter	4.64	3.42
Fourth quarter	5.38	3.74
Fiscal 2004:		
First quarter	$ 6.36	$ 4.63
Second quarter	5.84	4.58
Third quarter	5.00	3.61

The equity compensation plan information incorporated by reference into Part III, Item 12 of this Form 10-K is hereby incorporated by reference into this Part II, Item 5.

As of November 30, 2005, there were 1,086 stockholders of record and the last reported sale price of our common stock on the Nasdaq National Market was $6.22 per share.

Dividend Policy

We have never declared or paid any cash dividends on our capital stock. We currently expect to retain future earnings, if any, to finance the growth and development of our business and do not anticipate paying any cash dividends in the foreseeable future.

Our loan and security agreement with Silicon Valley Bank, as amended on March 31, 2004, and again on March 31, 2005 contains a restrictive covenant which prohibits us from paying or declaring any dividends on our capital stock during the term of the agreement (except for dividends payable solely in capital stock) without Silicon Valley Bank s prior written consent. In addition, the zero coupon convertible subordinated debenture due in January 2006 that was issued to Koninklijke Royal Philips Electronics N.V. in connection with our acquisition of the Speech Processing Telephony and Voice Control business units of Philips contains a restrictive covenant which prohibits us from paying or declaring any dividend or distribution (other than distributions of our equity securities) on our capital stock while the debenture is outstanding. This restriction terminates if one half or more of the debenture is converted by Philips into our common stock.

We have not publicly announced any currently effective authorization to repurchase shares of our common stock. However, upon vesting of restricted stock awards, employees are permitted to return to us a portion of the newly vested shares to satisfy the tax withholding obligations that arise in connection with such vesting. The following table summarizes fiscal 2005 repurchases of our common stock, which represent shares returned to satisfy tax withholding obligations:

Period	Total Number of Shares Purchased(1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs

July 1, 2005 through July 31, 2005		$	
August 1, 2005 through August 31, 2005	32,043		5.17
September 1,2005 through September 30, 2005	18,384		5.18
Total	50,427	$	5.17

(1) In fiscal 2005, a total of 75,354 shares of our common stock were returned to us to satisfy tax withholding obligations. The average price paid for these shares was $4.80 per share.

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Item 6. ***Selected Financial Data***

On October 23, 2004, our Board of Directors approved a change in the Company s fiscal year end from December 31 to September 30, effective beginning September 30, 2004. All references in this Form 10-K to the period ended September 30, 2004 refer to the nine months ended September 30, 2004. References to fiscal 2005, refers to the period beginning on October 1, 2004 and ending on September 30, 2005. References to fiscal 2003, refers to the period beginning January 1, 2003 and ending on December 31, 2003.

The following selected consolidated financial data is not necessarily indicative of the results of future operations and should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and related notes included elsewhere in this Annual Report on Form 10-K. The interim statement of operations for the nine months ended September 30, 2003 is unaudited and, in the opinion of management, reflects all adjustments, consisting of normal recurring adjustments, necessary for a fair statement of results of operations for the nine months ended September 30, 2003.

	Year Ended September 30, 2005(4)	Nine Month Period Ended September 30, 2004(3)	Year Ended December 31, 2003(2)	2002	2001(1)	Nine Months Ended September 30, 2003 (Unaudited)
			(In thousands)			
Consolidated Statement of Operations Data:						
Total revenue	$ 232,388	$ 130,907	$ 135,399	$ 106,619	$ 62,717	$ 88,529
Gross margin	163,317	89,179	98,760	80,730	35,676	65,405
Income (loss) from operations	2,032	(7,993)	(6,462)	6,603	(16,931)	(7,033)
Income (loss) before income taxes	1,395	(8,045)	(5,787)	6,587	(17,194)	(6,375)
Provision for (benefit from) income taxes	6,812	1,333	(269)	254	(317)	473
Net income (loss)	$ (5,417)	$ (9,378)	$ (5,518)	$ 6,333	$ (16,877)	$ (6,848)
Net income (loss) per share:						
basic and diluted	$ (0.05)	$ (0.09)	$ (0.07)	$ 0.09	$ (0.34)	$ (0.10)
Weighted average common shares outstanding:						
Basic	109,540	103,780	78,398	67,010	49,693	71,286
Diluted	109,540	103,780	78,398	72,796	49,693	71,286

	As of September 30,		As of December 31,		
	2005	2004	2003	2002	2001
			(In thousands)		
Consolidated Balance Sheet Data:					
Cash, cash equivalents and short and long-term investments	$ 95,814	$ 47,691	$ 42,584	$ 18,853	$ 14,324
Working capital	12,130	27,940	44,305	16,842	9,318
Total assets	757,212	392,653	401,940	143,690	142,070
Long-term debt	35	27,700	27,859		3,273
Total stockholders equity	514,665	301,745	303,226	119,378	114,534

See Note 3 of Notes to Consolidated Financial Statements for further information on our acquisitions made during fiscal 2005, 2004 and 2003.

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(1) On December 12, 2001, the Company acquired the Speech and Language Technology Business of Lernout & Hauspie Speech Products, N.V.

(2) On January 30, 2003, the Company acquired Royal Philips Electronic Speech Processing Telephony and Voice Control business units, and related intellectual property.
On August 11, 2003, the Company acquired SpeechWorks International, Inc.
On December 19, 2003, the Company acquired LocusDialog, Inc.

(3) On June 15, 2004, the Company acquired Telelogue, Inc.
On September 16, 2004, the Company acquired Brand & Groeber Communications GbR.

(4) On December 6, 2004, the Company acquired Rhetorical Systems, Ltd.
On January 21, 2005, the Company acquired ART Advanced Recognition Technologies, Inc.
On February 1, 2005, the Company acquired Phonetic Systems Ltd.
On May 12, 2005, the Company acquired MedRemote, Inc.
On September 15, 2005, the Company acquired Nuance Communications, Inc.

Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

The following discussion of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes thereto included elsewhere in this Annual Report on Form 10-K. This discussion contains forward-looking statements, which involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements for many reasons, including the risks described in Risk Factors starting on page 31 and elsewhere in this Annual Report.

Forward-looking Statements

This annual report contains forward-looking statements. These forward-looking statements include predictions regarding:

OUR FUTURE REVENUE, COST OF REVENUE, RESEARCH AND DEVELOPMENT EXPENSES, SELLING, GENERAL AND ADMINISTRATIVE EXPENSES, AMORTIZATION OF OTHER INTANGIBLE ASSETS AND GROSS MARGIN;

OUR STRATEGY RELATING TO SPEECH AND IMAGING TECHNOLOGIES;

THE POTENTIAL OF FUTURE PRODUCT RELEASES;

OUR PRODUCT DEVELOPMENT PLANS AND INVESTMENTS IN RESEARCH AND DEVELOPMENT;

FUTURE ACQUISITIONS;

INTERNATIONAL OPERATIONS AND LOCALIZED VERSIONS OF OUR PRODUCTS; AND

LEGAL PROCEEDINGS AND LITIGATION MATTERS.

You can identify these and other forward-looking statements by the use of words such as may, will, should, expects, plans, anticipates, believes, estimates, predicts, intends, potential, continue or the negative o other comparable terminology. Forward-looking statements also include the assumptions underlying or relating to any of the foregoing statements.

Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including those set forth in this annual report under the heading Risk Factors . All forward-looking statements included in this document are based on information available to us on the date hereof. We assume no obligation to update any forward-looking statements.

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Overview of the Business

We offer businesses and consumers competitive and value-added speech and imaging solutions that facilitate the way people access, share, manage and use information in business and in daily life. We market and distribute our products indirectly through a global network of resellers, comprising system integrators, independent software vendors, value-added resellers, hardware vendors, telecommunications carriers and distributors; and directly to businesses and consumers through a dedicated direct sales force and our e-commerce website *(www.nuance.com)*. The value of our solutions is best realized in vertical markets that are information and process intensive, such as healthcare, telecommunications, financial services, legal and government.

Our strategy is to deliver premier, comprehensive technologies and services as an independent application or as part of a larger integrated system in two areas speech and imaging. Our speech technologies enable voice-activated services over a telephone, transform speech into written word, and permit the control of devices and applications by simply speaking. Our imaging solutions eliminate the need to manually reproduce documents, automate the integration of documents into business systems, and enable the use of electronic documents and forms within database, Internet, mobile and other business applications. Our software is delivered as part of a larger integrated system, such as systems for customer service call centers, or as an independent application, such as dictation, document conversion or PDF, navigation systems in automobiles or digital copiers on a network. Our products and technologies deliver a measurable return on investment to our customers.

Our extensive technology assets, intellectual property and industry expertise in speech and digital capture provide us with a competitive advantage in markets where we compete. Our technologies are based on complex mathematical formulas, which require extensive amounts of linguistic and image data, acoustic models and recognition techniques. A significant investment in capital and time would be necessary to replicate our current capabilities, and we continue to build upon our leadership position. Our speech technology has industry-leading recognition accuracy, provides recognition for 46 languages and natural sounding synthesized speech in 25 languages, and supports a broad range of hardware platforms and operating systems. Our digital capture technology is recognized as the most accurate in the industry, with rates as high as 99.8%, and supports more than 100 languages. Our technologies are covered by more than 500 patents or patent applications. Our intellectual property, whether purchased and included as an asset on our balance sheet, or developed internally and thus not generally included on our balance sheet, is critical to our success and competitive position, and ultimately to our market value. We rely on a combination of patents, copyrights, trademarks, services marks, trade secrets, confidentiality provisions and licensing arrangements to establish and protect our intellectual property and proprietary rights.

Our strategy includes participating broadly in speech, pursuing opportunities for dictation in the healthcare industry and other key vertical markets, expanding our PDF and imaging solutions, providing our partners and customers with a comprehensive portfolio of solutions, promoting the broad adoption of our technology, building global sales and channel relationships and pursuing strategic acquisitions that complement our resources.

Nuance was incorporated in 1992 as Visioneer. In 1999, we changed our name to ScanSoft, Inc. and ticker symbol to SSFT. In October 2005, we changed our name to Nuance Communications, Inc., and in November 2005 we changed our ticker symbol to NUAN. From our founding until 2001, we focused exclusively on delivering imaging solutions that simplified converting and managing information as it moved from paper formats to electronic systems. On March 13, 2000, we merged with Caere Corporation, a California-based digital imaging software company, to expand our applications for document and electronic forms conversion. In December 2001, we entered the speech market through the acquisition of the Speech & Language Technology Business from Lernout & Hauspie. We believed speech solutions were a natural complement to our imaging solutions as both are developed, marketed and delivered through similar resources and channels. We continue to execute against our strategy of being the market leader in speech through the organic growth of our business as well as through strategic acquisitions. Since the beginning of fiscal 2003, we have completed a number of acquisitions, including:

On January 30, 2003, we acquired Royal Philips Electronics Speech Processing Telephony and Voice Control business units (Philips) to expand our solutions for speech in call centers and within automobiles and mobile devices.

On August 11, 2003, we acquired SpeechWorks International, Inc. (SpeechWorks) to broaden our speech applications for telecommunications, call centers and embedded environments as well as establish a professional services organization.

On December 19, 2003, we acquired LocusDialog, Inc. (LocusDialog) to expand our speech application portfolio with automated attendant solutions for business.

On June 15, 2004, we acquired Telelogue, Inc. (Telelogue) to enhance our automated directory assistance solutions.

On September 16, 2004, we acquired Brand & Groeber Communications GbR (B&G) to enhance our embedded speech solutions, which will make mobile phones accessible to the visually impaired using Nuance s text-to-speech technology.

On December 6, 2004, we acquired Rhetorical Systems, Inc. (Rhetorical) to complement our text-to-speech solutions and add capabilities for creating custom voices.

On January 21, 2005, we acquired ART Advanced Recognition Technologies, Inc. (ART) to expand our portfolio of speech solutions for handsets and mobile devices.

On February 1, 2005, we acquired Phonetic Systems Ltd. (Phonetic) to complement our solutions and expertise in automated directory assistance and enterprise speech applications.

On May 12, 2005, we acquired MedRemote, Inc. (MedRemote) to expand our position in healthcare markets and provide a more comprehensive dictation solution for medical providers and organizations.

On September 15, 2005, we acquired Nuance Communications, Inc. (Former Nuance) to expand our portfolio of technologies, applications and services for call center automation, customer self service and directory assistance.

Our focus on providing competitive and value-added solutions for our customers and partners requires a broad set of technologies, service offerings and channel capabilities. We have made and expect to continue to make acquisitions of other companies, businesses and technologies to complement our internal investments in these areas. We have a team that focuses on evaluating market needs and potential acquisitions to fulfill them. In addition, we have a disciplined methodology for integrating acquired companies and businesses after the transaction is complete.

CRITICAL ACCOUNTING POLICIES, JUDGMENTS AND ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenue and expenses during the reporting periods. On an ongoing basis, we evaluate our estimates and judgments, in particular those related to revenue recognition, the costs to complete the development of custom software applications and valuation allowances (specifically sales returns and other allowances); accounting for patent legal defense costs; the valuation of goodwill, other intangible assets and tangible long-lived assets; estimates used in the accounting for acquisitions; assumptions used in valuing stock-based compensation instruments;

evaluating loss contingencies; and valuation allowances for deferred tax assets. Actual amounts could differ significantly from these estimates. Our management bases its estimates and judgments on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities and the amounts of revenue and expenses that are not readily apparent from other sources. These estimates and judgments are discussed with, and reviewed by, the audit committee of our board of directors.

We believe the following critical accounting policies most significantly affect the portrayal of our financial condition and results of operations and require our most difficult and subjective judgments.

Revenue Recognition

As a result of our SpeechWorks acquisition in August 2003, professional services became a material component of our business. As a result of this and the implementation of Oracle, in January 2004, we began to separately track and disclose professional services revenue and cost of revenue. Prior to 2004, we did not separately disclose professional services revenue and cost of revenue as they were immaterial and it is not practical to reclassify these revenues and associated costs retroactively.

We recognize revenue in accordance with Statement of Position (SOP) 97-2, Software Revenue Recognition, as amended by SOP 98-9, Modification of SOP 97-2 with Respect to Certain Transactions , SOP 81-1 Accounting for Performance of Construction Type and Certain Performance Type Contracts and the Securities and Exchange Commission s Staff Accounting Bulletin 104, Revenue Recognition in Financial Statements (SAB 104) and Emerging Issues Task Force (EITF) 01-9 Accounting for Consideration Given by a Vendor (Including a Reseller of the Vendor s Products) , Statement of Financial Accounting Standards (SFAS) 48 Revenue Recognition When Right of Return Exists and EITF 01-14, Income Statement Characterization of Reimbursements for Out-of-Pocket Expenses Incurred . In general we recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, collectibility is probable, and vendor specific objective evidence (VSOE) exists for any undelivered elements. We reduce revenue recognized for estimated future returns, price protection and rebates and certain marketing funds.

Certain distributors and value-added resellers have been granted rights of return for as long as the distributors or resellers hold the inventory. We have not aggregated and analyzed historical returns from distributors and resellers to form a basis in order to estimate the future sales returns by distributors and resellers. As a result, we recognize revenue from sales to these distributors and resellers when they have sold products through to retailers and end-users. Title and risk of loss generally pass to the distributor or reseller upon shipment from us, at which time the transaction is invoiced and payment is due. Based on reports from distributors and resellers of their inventory balances at the end of each period, we record an allowance against accounts receivable and a reduction of revenue for the sales price of all inventories subject to return.

We also make an estimate of sales returns by retailers or end users directly or through our distributors or resellers based on historical returns experience. We have aggregated and analyzed historical returns from retailers and end users which forms the basis of our estimate of future sales returns by retailers or end users. In accordance with SFAS 48, the provision for these estimated returns is recorded as a reduction of revenue at the time that the related revenue is recorded. If actual returns from retailers differ significantly from our estimates, such differences could have a material impact on our results of operations for the period in which the actual returns become known. Our accounts receivable balance was $69.5 million and $36.5 million at September 30, 2005 and 2004, respectively. These balances are net of sales returns and other allowances of $10.1 million and $8.8 million and allowances for doubtful accounts of $3.5 million and $2.5 million as of September 30, 2005 and 2004, respectively.

Revenue from royalties on sales of our products by OEMs to third parties, where no professional services are included, is typically recognized upon delivery to the third party when such information is available, or when we are notified by the OEM that such royalties are due as a result of a sale, provided that all other revenue recognition criteria are met.

When we provide professional services considered essential to the functionality of the software, such as custom application development for a fixed fee, we recognize revenue from the fees for such services and any related software licenses based on the percentage-of-completion method in accordance with SOP 81-1. We generally determine the percentage of completion by comparing the labor hours incurred to date to the estimated labor hours required to complete the project. We consider labor hours to be the most reliable available measure of progress on these projects. Adjustments to estimates to complete are made in the periods in which facts resulting in a change become known. When the estimate indicates a loss, such loss is recorded in the period identified. Significant judgments and estimates are involved in determining total estimated costs, and therefore the percent complete of each contract. If our estimates change, the adjustment could have a material effect on our results of operations in the period of the change.

When we provide services on a time and materials basis, we recognize revenue as we perform the services based on actual time incurred. Other professional services not considered essential to the functionality of the software are limited and primarily include training and feasibility studies, which are recognized as revenue when the related services are performed.

When we provide software support and maintenance services, we recognize the revenue ratably over the term of the related contracts, typically one year.

We may sell, under one contract or related contracts, software licenses, custom software applications and other services considered essential to the functionality of the software and a maintenance and support arrangement. The total contract value is attributed first to the maintenance and support arrangement based upon VSOE of its fair value, equal to its stated list price as a fixed percentage of the related software product s price and additionally based upon stated renewal rates. The remainder of the total contract value is then attributed to the software license and related professional services, which are typically recognized as revenue using the percentage of completion method. As a result, discounts inherent in the total contract value are attributed to the software license and related professional services. We may sell, under one contract or related contracts, software licenses, a maintenance and support arrangement and professional services not considered essential to the functionality of the software. In those arrangements, the total contract value is attributed first to the undelivered elements of maintenance and support and professional services based on VSOE of their respective fair values, as described above. The remainder of the contract value is attributed to the software licenses, which are typically recognized as revenue upon delivery, provided all other revenue recognition criteria are met. As a result, discounts inherent in the total contract value are attributed to the software licenses.

We follow the guidance of EITF 01-9 in determining whether consideration given to a customer should be recorded as an operating expense or a reduction of revenue recognized from that same customer. Consideration given to a customer is recorded as a reduction of revenue unless both of the following conditions are met:

We receive an identifiable benefit in exchange for the consideration, and the identified benefit is sufficiently separable from the customer s purchase of our products and services such that we could have purchased the products from a third party, and

We can reasonably estimate the fair value of the benefit received.

When the above conditions are not met, consideration, including that in the form of our equity instruments (if applicable), is recorded as a reduction of revenue, to the extent we have recorded cumulative revenue from the customer or reseller. As a result of this policy, we have recorded a $0.5 million, $0.3 million and $0.2 million reduction in total revenue for the fiscal year ended September 30, 2005, the nine months ended September 30, 2004 and the fiscal year ended December 31, 2003, respectively.

We follow the guidance of EITF 01-14, Income Statement Characterization of Reimbursements for Out-of-Pocket Expenses Incurred , and record reimbursements received for out-of-pocket expenses as revenue, with offsetting costs recorded as cost of revenue. Out-of-pocket expenses generally include, but are not limited to, expenses related to airfare, hotel stays and out-of-town meals.

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Accounting for Patent Legal Defense Costs

We have capitalized external legal costs incurred in the defense of our patents where we believe it is probable and to the extent that the future economic benefit of the patent will be increased. We monitor the legal costs incurred and the anticipated outcome of the legal action and, if changes in the anticipated outcome occur, write off capitalized costs, if any, in the period the change is determined. As of September 30, 2005 and 2004, capitalized patent legal defense costs were $2.3 million and $0.5 million, respectively.

Valuation of Long-lived Tangible and Intangible Assets and Goodwill

We have significant long-lived tangible and intangible assets and goodwill, which are susceptible to valuation adjustments as a result of changes in various factors or conditions. The most significant long-lived tangible and intangible assets other than goodwill, are patents and core technology, completed technology and trademarks, and fixed assets which are typically amortized using the straight-line method over their estimated useful lives. The values of intangible assets, with the exception of goodwill, were initially determined by a risk-adjusted, discounted cash flow approach. We assess the potential impairment of identifiable intangible assets and fixed assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable and at least annually. Factors we consider important, which could trigger an impairment of such assets, include the following:

Significant underperformance relative to historical or projected future operating results;

Significant changes in the manner of or use of the acquired assets or the strategy for our overall business;

Significant negative industry or economic trends;

Significant decline in our stock price for a sustained period; and

A decline in our market capitalization below net book value.

Future adverse changes in these or other unforeseeable factors could result in an impairment charge that would materially impact future results of operations and financial position in the reporting period identified.

Effective January 1, 2002, we adopted SFAS 142, Goodwill and Other Intangible Assets . SFAS 142 requires, among other things, the discontinuance of goodwill amortization. The standard also requires us to test goodwill for impairment on at least an annual basis. We use July 1st as the date of the annual impairment test. The impairment test compares the fair value of the reporting unit to its carrying amount, including goodwill, to assess whether impairment is present. We have reviewed the provisions of SFAS 142 with respect to the criteria necessary to evaluate the number of reporting units that exist, based on our review we have determined that we operate in one reporting unit. Based on this assessment test, we have not had any goodwill impairment charges during our history. We assess the impairment of goodwill more often if indicators of impairment arise. Due to the addition of $150.8 million of goodwill relating to our acquisition of Former Nuance, we reviewed the goodwill for impairment as of September 30, 2005, and again determined that no impairment exists.

In accordance with SFAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets , the Company periodically reviews long-lived assets for impairment whenever events or changes in business circumstances indicate that the carrying amount of the assets may not be fully recoverable or that the useful lives of those assets are no longer appropriate. Each impairment test is based on a comparison of the undiscounted cash flows to the recorded carrying value for the asset. If impairment is indicated, the asset is written down to its estimated fair value based on a discounted cash flow analysis. In fiscal 2005, a restructuring charge was recorded that included a $0.2 million charge related to certain leasehold improvements. No impairment charge was recorded in fiscal 2004. In fiscal 2003 a charge of $0.2 million was recorded relating to a portion of the technology acquired from Philips.

Significant judgments and estimates are involved in determining the useful lives of our intangible assets, determining what reporting units exist and assessing when events or circumstances would require an interim impairment analysis of goodwill or other long-lived assets to be performed. Changes in our organization or our management reporting structure, as well as other events and circumstances, including but not limited to technological advances, increased competition and changing economic or market conditions, could result in (a) shorter estimated useful lives, (b) additional reporting units, which may require alternative methods of estimating fair values or greater disaggregation or aggregation in our analysis by reporting unit, and/or (c) other changes in previous assumptions or estimates. In turn, this could have a significant impact on our consolidated financial statements through accelerated amortization and/or impairment charges.

Accounting for Acquisitions

We have completed a number of significant business and other asset acquisitions over the preceding five years which have resulted in significant goodwill and other intangible asset balances. Our future business strategy contemplates that we may continue to pursue additional acquisitions in the future. Our accounting for acquisitions involves significant judgments and estimates primarily, but not limited to: the fair value of certain forms of consideration, the fair value of acquired intangible assets, which involve projections of future revenues and cash flows, the fair value of other acquired assets and assumed liabilities, including potential contingencies, and the useful lives and, as applicable, the reporting unit, of the assets. Our financial position or results of operations may be materially impacted by changes in our initial assumptions and estimates relating to prior or future acquisitions. Additionally, under SFAS 142, we determine the fair value of the reporting unit, for purposes of the first step in our annual goodwill impairment test, based on our market value. If prior or future acquisitions are not accretive to our results of operations as expected, our market value declines dramatically, or we determine we have more than one reporting unit, we may be required to complete the second step which requires significant judgments and estimates and which may result in material impairment charges in the period in which they are determined.

Accounting for Stock-based Compensation Instruments

We apply the principles of SFAS 123 Accounting for Stock-based Compensation to value any grants of equity instruments to non-employees as well as to calculate pro forma information relative to our employee awards for disclosure purposes. Application of this principle inherently includes a number of estimates and assumptions including stock price volatility factors. We base our estimates and assumptions on the best information available at the time of valuation; however, changes in these estimates and assumptions including stock price volatility factors could have a material effect on the valuation of the underlying instruments.

Accounting for Long-Term Facility Obligations

We have historically acquired companies which have previously established restructuring charges relating to lease exit costs, and we have recorded restructuring charges of our own that include lease exit costs. We follow the provisions of EITF 95-3 Recognition of Liabilities in Connection with a Purchase Business Combination or SFAS 146 Accounting for Costs Associated with Exit or Disposal Activities , as applicable. In accounting for these obligations, we are required to make assumptions relating to the time period over which the facility will remain vacant, sublease terms, sublease rates and discount rates. We base our estimates and assumptions on the best information available at the time of the obligation having arisen. These estimates are reviewed and revised as facts and circumstances dictate; changes in these estimates could have a material effect on the amount accrued on the balance sheet.

Loss Contingencies

We are subject to legal proceedings, lawsuits and other claims relating to labor, service and other matters arising in the ordinary course of business. Quarterly, we review the status of each significant matter and assess our potential financial exposure. If the potential loss from any claim or legal proceeding is considered probable and the amount can be reasonably estimated, we accrue a liability for the estimated loss. Significant judgment is required in both the determination of probability and the determination as to whether an exposure is reasonably estimable. Because of uncertainties related to these matters, accruals are based only on the best information available at the time. As additional information becomes available, we reassess the potential liability related to our pending claims and litigation and may revise our estimates. Such revisions in the estimates of the potential liabilities could have a material impact on our results of operations and financial position.

Accounting for Income Taxes

As part of the process of preparing our consolidated financial statements, we are required to calculate our income tax expense based on taxable income by jurisdiction. There are many transactions and calculations where the ultimate tax outcome is uncertain. Some of these uncertainties arise as a consequence of revenue-sharing and cost-reimbursement arrangements among related entities and the differing tax treatment of revenue and cost items across various jurisdictions.

Additionally, we monitor the realization of our deferred tax assets based on changes in circumstances, for example, recurring periods of income for tax purposes following historical periods of cumulative losses or changes in tax laws or regulations. Our income tax provisions and our assessment of the realizability of our deferred tax assets involve significant judgments and estimates. If we continue to generate taxable income through profitable operations in future years we may be required to recognize these deferred tax assets through the reduction of the valuation allowance which would result in a material benefit to our results of operations in the period in which the benefit is determined, excluding the recognition of the portion of the valuation allowance which relates to net deferred tax assets acquired in a business combination and stock compensation.

OVERVIEW OF RESULTS OF OPERATIONS

On October 23, 2004, our Board of Directors approved a change in our fiscal year end from December 31 to September 30, effective beginning September 30, 2004. All references in this Form 10-K to the period ended September 30, 2004 refer to the nine months ended September 30, 2004, and are also referred to as fiscal 2004. References to fiscal 2005, refers to the period beginning on October 1, 2004 and ending on September 30, 2005. References to fiscal 2003, refers to the period beginning on January 1, 2003 and ending on December 31, 2003. References to fiscal 2006, refers to the period beginning on October 1, 2005 and ending on September 30, 2006.

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The following table presents, as a percentage of total revenue, certain selected financial data for the twelve months ended September 30, 2005, the nine months ended September 30, 2004 and September 30, 2003 and for the year ended December 31, 2003. The interim statement of operations for the nine months ended September 30, 2003 is unaudited and, in the opinion of management, reflects all adjustments, consisting of normal recurring adjustments, necessary for a fair statement of results of operations for the nine months ended September 30, 2003.

	Year Ended September 30, 2005	Nine Month Period Ended September 30, 2004	Year Ended December 31, 2003	Nine Months Ended September 30, 2003
				(Unaudited)
Revenue:				
Revenue(1)	73.7%	74.6%	100%	100%
Professional services	26.3	25.4		
Total revenue	100.0	100.0	100.0	100.0
Costs and expenses:				
Cost of revenue	8.8	7.9	19.3	17.7
Cost of professional services	17.0	17.5		
Cost of revenue from amortization of intangible assets	3.9	6.5	7.8	8.4
Gross Margin	70.3	68.1	72.9	73.9
Research and development	16.8	20.0	25.1	28.3
Sales and marketing	33.5	37.5	36.0	35.3
General and administrative	13.0	13.6	12.0	13.0
Amortization of other intangible assets(2)	1.7	1.5	1.7	1.6
Stock based compensation expense	1.3	1.0	0.2	0.2
Restructuring and other charges, net(3)	3.1	0.6	2.7	3.4
Total costs and expenses	99.1	106.1	104.8	107.9
Income (loss) from operations	0.9	(6.1)	(4.8)	(7.9)
Other income (expense), net	(0.3)			